No. 10228

IN THE

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE NINTH CIRCUIT

WASHMONT CORPORATION, a Corporation,
Appellant,

vs.

THOR W. HENRICKSEN, Individually, and as Acting Collector of Internal Revenue for the Western District of Washington, Southern Division, *Appellee.*

UPON APPEAL FROM DECISION OF UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON, SOUTHERN DIVISION

HONORABLE JOHN C. BOWEN, *Judge*

BRIEF FOR THE APPELLANT

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OPINION BELOW

The opinion of the District Court from which this Appeal is taken is not officially reported, but may be found in 1942 C.C.H. §9302.

JURISDICTION

This action was instituted by the appellant as plaintiff, for the recovery of income taxes alleged to have been wrongfully assessed and collected, under Section 24(b) of the Judicial Code as amended, and as qualified by Section 3772 I.R.C. From a decision adverse

to its claim, after trial by the court without a jury, this appeal is taken under Section 128(a) of the Judicial Code, as amended.

STATEMENT OF THE CASE

The taxes involved were assessed by the Commissioner of Internal Revenue, and collected by the appellee, for the calendar years 1937 and 1938, under the provisions imposing a surtax on personal holding companies (Section 351 of the Revenue Act of 1936, as amended by the Act of 1937, and Section 401 of the Revenue Act of 1938.) The provisions of the Internal Revenue Code, so far as concerns the question here involved, are identical with the provisions of the respective acts, and reference will therefore be made only to the Code. Section 500 I.R.C. imposes a surtax at certain rates upon the net income of every personal holding company. Section 501 I.R.C. defines a personal holding company as any corporation whose income is of a certain character and

> "(2) Stock Ownership Requirement. At any time during the last half of the taxable year, more than 50% in value of its outstanding stock is owned, directly or indirectly by not more than five individuals."

Appellant's income was of the character defined as personal holding company income. The only question involved in this proceeding arises under the stock ownership requirement, it being claimed by the appellant that during the last half of each of the taxable years, more than 50% in value of its outstanding stock was owned directly or indirectly by more than five individuals.

This contention turns upon whether certain securities issued by the appellant, designated as participating dividend debentures, held by Associated Breweries of Canada, Limited (hereinafter called "Associated"), are to be considered as stock or evidence of debt. Appellant's capital structure consisted of 25,000 shares of common stock, par value $1.00 each, all held by one individual, and $625,000 of such participating debentures, all held by Associated, which in turn had several hundred shareholders and whose stock was not owned to the extent of 50% either directly or indirectly by not more than five individuals (R. 30). Appellant claims that the debentures should be classified as stock,and, if so, then the personal holding company tax would not apply. The only question presented upon this appeal is a determination of the nature or character of such securities.

SPECIFICATION OF ERRORS

1. The trial court erred in holding that the issued debentures constituted a debt and not a stock or equity interest (R. 24) and in failing to hold that such securities were not and were not intended to be or create an indebtedness against the appellant, rather than an equity interest at risk in the business, as set forth in Finding 8 (R. 31).

2. In considering the evidence offered in support of appellant's claim, the lower court erred in refusing to receive and consider an offer of proof made by appellant to the effect that when the Revenue Agent's office indicated that it would hold the debentures to be a debt rather than stock, and would

classify appellant as a personal holding company, the appellant and Associated forthwith took steps to cause the debentures to be exchanged for and replaced by an issue of preferred stock (R. 45), and in refusing to receive and consider the minutes and records supporting such offer (R. 72-75). Such evidence was objected to "on the ground it is not relevant to the issues in this case as to what was done later" and sustained by the court "on the time element, particularly" (R. 45).

SUMMARY OF ARGUMENT

The debentures were never intended to create a debt, or to constitute the holder a creditor of appellant, but were intended and should be construed to represent an equity interest in capital at risk in the business, and should therefore be classified as stock for purposes of determining application of the personal holding company tax.

The wording of the debentures is entirely different from that of ordinary bonds or evidences of debt, and is more indicative of a capital investment in the nature of preferred stock. In addition, the circumstances giving rise to the issuance of the debentures and the purpose and intent with which they were created clearly stamp them as capital at risk in the business, which should be treated as stock in applying the personal holding company statute.

More concretely, we shall discuss the above propositions under the following headings:

1. The provisions of the debentures are in themselves indicative of preferred stock rather than a debt.

2. The intent and purpose of the parties established their status as capital at risk in the business.
3. The trial court refused to receive proper and material evidence of purpose, or to give proper consideration to evidence admitted. It's opinion does not recognize the realities of the situation or apply the rules of the decided cases.
4. All of the essential elements of the debentures have been recognized as attributes of preferred stock and the great weight of authority stamps them as stock rather than evidence of debt.

ARGUMENT

1. The Provisions of the Debentures Denote an Equity Interest Rather than a Debt.

We shall deal *seriatim* with the significant provisions of the obligations (R. 64), with incidental reference to their legal aspect, which, however, will be developed more fully under Section 4 of the argument.

The instrument is called a "participating dividend debenture." While the word "debenture" signifies a debt, the qualifying phrase "participating dividend" indicates characteristics peculiar to stock, such as sharing in the assets and receiving a return according to earnings. It is significant that the obligation is not called a bond or a note, and its title is as consistent with an equity interest as a debt.

While the name by which the instrument is called may have a bearing, it is not at all conclusive. "They (the cases) all agree that the question for decision in each case is, not what the payments are called, but what in fact, they are, and if taken as a whole, the

evidence shows a relation of debtor and creditor, the payments made on account of that relation, will be interest, no matter how called, while if taken as a whole, the evidence shows a stockholding relation, the payments made will be dividends, equally no matter how called." *U. S. v. South Georgia Railway* (C.C.A. 5) 107 F. (2d) 3, 39-2 U.S.T.C. §9765.

Angelus Bldg. & Inv. Co., 20 B.T.A. 667.

Appellant "acknowledges itself indebted and promises to pay * * * on or before 20 years from date." This is the most definite and specific indication of a debt to be found in the entire instrument, and taken by itself would support the holding of indebtedness. But it must be considered in connection with all of the other provisions of the instrument, and when so considered it amounts to nothing more in substance than the fixing of a definite date for retirement of the interest represented by the debentures, which is a usual incident of preferred stock and has in many cases been held not to prevent classification of the instrument as stock rather than an evidence of debt.

The undertaking is to pay to "the registered owner," not to bearer or order. The amount to be paid is not definitely ascertainable, but is either the face amount or "such other sum as shall be required for retirement in accordance with the terms hereof." These provisions render the instrument non-negotiable. Rem. Rev. Stat. of Washington §3392-3.

The obligation is made "a lien upon the property and net earnings of the company." However, there was no accompanying mortgage or pledge of specific

property and the evidence shows that it was not supplemented by any such security (R. 54). It is simply a general charge against the company's assets similar to the preference or distributive status generally provided in favor of preferred stock. Considering the further provision that all net earnings of the company are required to be divided currently between the holders of the debentures and of the common stock, making it impossible to build up from earnings any fund or surplus to meet the debentures, it is obvious that they can be ultimately retired only out of capital, in what, from a practical standpoint, will be a liquidation of the company.

Such a provision has been considered and held in many cases not to be inconsistent with the equity character of the obligation, a provision for a lien on the assets being very often an element of preferred stock. In *Spencer v. Smith* (C.C.A. 2) 201 Fed. 647, the certificate provided for a guarantee of dividends and the redemption of the principal on or before 10 years, and as security for such obligation there had been executed and delivered to a trust company a first mortgage lien upon all of its property, yet it was held to be preferred stock and not a debt. See also 124 A.L.R. 1070 and 29 A.L.R. 254, 262.

The debenture provides for a return by way of interest and dividends. The interest is to be 3% but "is only payable out of the net earnings of the company for each fiscal year." This, of course, is wholly inconsistent with the usual characteristics of a debt, on which interest is payable regardless of earnings, and before any such thing as net earnings can be de-

termined. "The interest to be paid to them is not to be paid absolutely, as to a creditor, but only out of net earnings, the same fund out of which the dividends on common stock are to be paid. Though called interest, it is really a dividend, because to be paid on stock and out of net profits." *Warren v. King*, 108 U.S. 389, 27 L.ed. 769.

After payment of such interest, if earned, an equalizing sum shall be paid upon the common stock, and the balance of the annual net earnings must be divided and distributed ratably between them, such distribution being characterized as "participating dividends." Such payments, being dispositions out of net earnings, are in the nature of dividends as defined in Section 115 of the Revenue Act of 1936. See also article 23(b) regulations 94, respecting deductions for interest. cf. *Pacific Southwest Realty Co. v. Comm.* (C.C.A. 9) 128 F. (2d) 815, 42-1 U.S.T.C. §9526, in which securities redeemable at a fixed time, then to be treated and enforced as a debt, but with annual payments or return only out of profits, are held to be stock.

The obligation is redeemable either at maturity or upon notice at an intermediate date by paying the principal, and interest, if earned and unpaid, together with accrued dividends unpaid, "plus a premium equal to the excess of the book value of the then assets of the corporation over the par value of its outstanding common stock and face value of the debentures of this issue then outstanding, ratably apportioned to such common stock and to such debentures." This is not such a provision as is ordinarily, if ever, found

in a bond or a note. Not only is it wholly inconsistent with the notion of a debt, but a literal application of the provision definitely stamps the obligation as being necessarily deferred and subordinate to the claims of all other creditors, because otherwise it would lead to the absurd and impossible result that the debenture holders would take precedence over all other creditors and the latter would be frozen out entirely. It should be noted that the premium must be paid whether upon liquidation, redemption or maturity. Such premium, according to the literal wording of the agreement, absorbs the entire difference between the face or par value of the stock and debentures, and the book value of the company's assets. The debentures would, on the present capitilization, take substantially all of such excess. There would be nothing left for other creditors, if such provisions be given their literal effect.

Even if such provisions would not wholly exclude other creditors they would at any rate seriously impair their position if the debentures constitute a debt. As pointed out above, the requirement of equal distribution of all earnings would prevent the current accumulation of any surplus except possibly from appreciation in value of capital assets (even this is doubtful), so that upon retirement or redemption the company will probably have nothing beyond its original capital assets. If the debentures are considered a debt supported by a lien, as respondent will no doubt contend, they would, by reason thereof, exclude all other creditors; if an unsecured debt, they would at least pro-rate with other creditors. If the debentures,

as a debt, are entitled to enforce the provision for a premium, absorbing the difference between the face of outstanding stock and debentures and the total book value of the company's assets, then even though they should rank and participate with other creditors as to their principal, there would necessarily be a pro-ration, so whether there is a lien or not, the other creditors would lose either all or part of their claims, while the debenture holder might receive more than the par value of its obligation. This is obviously an unreasonable and unsupportable construction. The only reasonable conclusion that can be drawn, and the only practicable interpretation that can be placed on the provisions is that it was assumed and intended that the creditors would come first in any event and required no further consideration, and the debenture holders are necessarily subordinate to other liability. While they have certain preferences and superior rights as against the common stock, these are only differences in equity ownership. They cannot be both a stock and a bond, but must be either one or the other.

Considering all of the provisions as a whole, they differ from and are inconsistent with the usual provisions of indebtedness and in view of the extreme and impossible results of giving them recognition as a debt, the only conclusion that can be logically supported is that they represent equity capital at risk in the business, and should be so considered in the application of the personal holding company statute.

2. Intent and Purpose in Creation of the Debentures.

In determining the character of the instrument the court is not limited simply to its terms but is entitled to consider relevant circumstances and particularly the intent and purpose of the parties in creating it. This court has especially committed itself to the position that in cases of this type "the real intention of the parties is to be sought and in order to establish it evidence *aliunde* the contract is admissible." *Comm. v. Proctor Shop*, 82 F. (2d) 792, 36-1 U.S.T.C. §9203; *Comm. v. Palmer, Stacy, Merrill, Inc.* (C.C.A. 9) 111 F. (2d) 809, 40-1 U.S.T.C. §9465; *Pac. S. W. Realty Co. v. Comm.*, 128 F. (2d) 815, 42-1 U.S.T.C. §9526.

There being no dispute or contradiction in the testimony, this court is not bound by the trial judge's findings of fact and the case is "one for the determination * * * of the legal effect of the facts as the record presents them, clearly, simply and without controversy." *U. S. v. South Georgia Realty* (C.C.A. 5) 107 F. (2d) 3, 39-2 U.S.T.C. §9765.

The review is less restricted here than upon a case decided by the Board, whose findings on the facts are made conclusive by statute, so that the following is even more applicable here:

> "Courts will not weigh evidence nor will they substitute their opinion for that of the Board where there is a conflict in the evidence and the findings of the Board are sustained by substantial evidence. But where there is no conflict in the evidence, the legal conclusions to be drawn therefrom present questions of law, and we will

inquire to ascertain whether the undisputed facts sustain the conclusions of the Board."

Farmer, et al. v. Comm. (C.C.A. 10) 126 F. (2d) 542, 1942-1 U.S.T.C. §9335.

The foregoing is but a specific expression of the general rule applicable in tax cases stated by Mr. Justice Black in *Helvering v. Lazarus*, 308 U.S. 252, 39-2 U.S.T.C. §9793, as follows:

"In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding."

The undisputed testimony shows the following:

Associated Breweries of Canada, Ltd., is the parent organization, of which various companies incorporated in the United States are offshoots, started after the repeal of prohibition. Mr. Emil G. Sick, the president, and one of the directors of Associated, organized these various United States breweries, in which Associated held substantial interests. The principal of these was Seattle Brewing and Malting Company of which Mr. Sick was also president, and in connection with which he established himself as a resident of Seattle. It was considered desirable to have voting control of these stocks localized and lodged with a citizen of the State of Washington, and Mr. Sick was selected to act for that purpose. The means of accomplishing this was by forming the appellant, Washmont Corporation, with a comparatively small amount of voting common stock, which was issued to Mr. Sick and his nominees in exchange for his stock in the local breweries, and by having Associated turn over the stocks held by it in the subsidiary com-

panies in exchange for an interest which was intended and supposed to be on a par with the common stock except that it would not have voting privileges (R. 43, 56).

The reason they did not represent Associated's interest by an issue of preferred stock was the fear that it might violate restrictions of Washington and Montana with respect to alien land ownership, as the companies, which would then be controlled by Washmont, were the owners of real estate. This was the only reason it was not set up as an authorized capital stock (R. 44). The officers and directors of Associated participated in the planning and setting up of the appellant and it was the intent of all parties (Mr. Ker and Mr. Bronson representing Associated; Mr. Sick representing Associated and Washmont, as well as Seattle Brewing and Malting Co., and the other local companies; and Mr. Chadwick, who organized Washmont) that Associated's interest was to be the same as Mr. Sick's interest represented by the common capital stock, except that it should not be called stock and should not have any voting power, and that it was not considered a debt, but in all respects subject to liabilities to creditors (R. 43, 44, 53, 55 and 60). It was never intended that the debentures would rank with other claims or liabilities, but, on the contrary, it was intended that they should be subordinate to its debts and should constitute capital at risk in the business. This was specifically discussed at the time the corporation was formed, and it was definitely understood by the representatives of both Associated and Washmont that the debentures did not constitute

debts but simply an interest in the business on a par with the common stock, except as to the right to vote (R. 44, 53, 56, 60).

No steps were ever taken to fix a lien upon the assets beyond the debenture itself (R. 54). Shortly after the formation of Washmont it had occasion to borrow money, and in all of its transactions with the bank, the latter was assured and made its loans upon the understanding that the debentures were capital and not a debt (R. 39, 56). It had no other creditors.

Another significant fact, which, however, the trial court refused to consider, is that as soon as the question was raised by the revenue agent about the character of these obligations, the parties immediately took steps to definitely settle their status by converting them into an authorized issue of preferred stock (R. 45, 72).

The court sustained an objection to appellant's offer of proof to this effect, which action is assigned as error upon this appeal. The court said "the objection is sustained on the time element particularly" (R. 45). Just what was meant by this is uncertain, as the only objection was on the ground of relevancy. We appreciate that such action is in a sense self-serving as to appellant, and were it confined to a declaration rather than an affirmative act having substantial consequences, it might be rejected on that ground. Even that objection, however, would not apply to the action taken by Associated in making such readjustment of interest. Such change would be substantially to its detriment, if a creditor, and the fact that it permitted and accepted the change is consistent only with

its position that from the beginning it intended to have nothing more than an equity interest, and is strong proof that it never intended to occupy the position of a creditor. The action has strong probative value from a practical standpoint in support of the understanding covered by the direct testimony that the debentures were in fact an equity interest at risk in the business and not a debt, and should have been received and considered for that purpose.

> "The object of a legal investigation is the elicitation of the truth, and to effectuate such object, all facts are admissible in evidence which afford reasonable inferences, or which throw any light upon the subject matter contested. No competent means of ascertaining the truth should be neglected—much less inhibited; and none are to be decreed incompetent unless such means have been shown by reason and experience to prevent or obscure the truth, instead of discovering it."
>
> *Callihan v. Wash. Water Power Co.*, 27 Wash. 154 at 158.

Even where a contract is not ambiguous, in determining the intent and arriving at a reasonable construction, it is proper to consider the circumstances surrounding the transaction, including the way in which the parties themselves later treated it.

> *Tholme v. Soundview Pulp Company*, 181 Wash. 3, at 21, 22.
>
> *Indianapolis Glove Company v. U. S.* (C.C. A. 7) 96 F. (2d) 816, 38-1 U.S.T.C. §9235.

But whether the rejected evidence be received or not, the positive, direct and uncontradicted testimony

of the witnesses who participated in and controlled the transaction involving the formation of Washmont and the issuance of the debentures, unequivocably establishes their character as capital at risk in the business and not a debt. Certainly in the face of the facts disclosed by such evidence, no creditor of the company would ever be required to suffer either subordination to or pro-ration with the debentures.

3. The Lower Court Failed to Recognize the Established Facts or Apply the Principles of the Decided Cases.

In its disposition of the case, the trial court avoided and refused to consider the purpose and intent of the parties as established by the uncontradicted testimony as well as the actualities of the situation under which appellant was formed, and the debentures issued. We do not mean that he discredited the testimony of the witnesses, for he accepted and relied upon their statements wherever they fitted into his view of the case and the conclusion he had reached. He could not well have declined to believe them, for the testimony was not only in no wise contradicted, impeached, or inherently improbable, but came from witnesses of the highest character. Mr. Chadwick, who handled the transactions resulting in the organization of Washmont, is a member of the bar of this court (R. 42); Mr. Brygger is president of the Peoples National Bank of Washington (R. 38); Mr. Sick is a substantial businessman (R. 55), and Mr. Hoover, who handled the accounts and returns is the Seattle manager of Price-Waterhouse, Inc. (R. 61). The trial judge apparently accepted their testimony but attempt-

ed to neutralize the portions thereof favorable to appellant and which did not fit into his conclusions by a species of dialectic reasoning which entirely ignored the substantial realities.

The court began by saying that Associated's interest was something other than a legal stock certificate (R. 20). That is true, with respect to name or form, but not as to substance. The witnesses stated that it was desired to avoid having the interest set up as an authorized issue of stock for the reason that this would constitute alien control of Washmont, which might create complications by reason of the ownership of lands in Washington and Montana by local companies, which Washmont in turn controlled (R. 44, 59, 60).

But then the court goes on to discuss the debenture as if it were something that Washmont was endeavoring to induce Associated to acquire, treating Associated as if it were an outsider which Washmont was trying to pursaude to become interested in its business—presumably as a creditor. The court speaks of such inducement taking the form of provision for participation in earnings and assets in return for giving up its vote, and in this connection refers to the certificate holders receiving "a guaranteed interest rate" (R. 20). That is a mistake upon a vital and significant point because the interest was not guaranteed and payable in any event, but to be received only if earned.

In further reasoning along the same line (R. 22) the court indulged in pure speculation of "talking points" held out as inducement to Associated to take the certificates. The court's whole approach to con-

sideration of the subject seemed to be founded upon a strained interpretation and erroneous understanding of the situation, which he viewed as a transaction occurring between strangers dealing at arms length, overlooking the real situation that this was in substance a reorganization promoted and carried out equally, if not more primarily, for the benefit of Associated. It was not being induced or persuaded at all, but on the contrary, was really the moving party seeking to bring about a corporate set up that would enable it to participate in the company without appearing as a record holder of authorized stock.

The court was apparently using this method of reasoning, perhaps unconsciously, to destroy or eliminate the force of the testimony and so disregard everything except the debenture itself. The court nowhere squarely met and decided whether the certificates were actually intended to be a debt or a creditor obligation. Intent, where material, is a fact to be proved by the direct testimony of the parties entertaining it. *Vons Investment Company v. Comm.* (C.C.A. 9) 111 F. (2d) 440, 40-1 U.S.T.C. §9441. When the court was pressed for a direct finding upon the fact of intent, it was avoided with the statement that "I feel that the written instrument has to govern that intention" (R. 25).

The court recognized (R. 22) that the certificates were intended and treated as capital at risk in the business when Washmont dealt with its bank, which was its only creditor (R. 22, 39). On the other hand, said the court, the appellant claimed a deduction of 3% interest paid on the debentures, thus indicating

that it considered them a debt (R. 22, 23), and therefore, by offsetting these two points, reached the conclusion that the testimony should be disregarded entirely. That, we submit, is specious reasoning, which falls short of meeting the fundamental question of intent. Granted that appellant did claim an interest deduction to which it was not entitled, still at the same time it was also claiming that a much larger portion of the payments made on the certificates represented dividends, treated in its tax return as a distribution to stockholders (R. 61), a course which was followed in subsequent years (see R. 62, 69, 71). Even though it made an erroneous claim, it contained no element of estoppel and there is no justification for treating that as conclusive against it. The Commissioner was put on notice of the facts and that the instrument could not be both a debt and stock. It was either one or the other. "It is fundamental that the stock in controversy cannot be both capital stock and loans. Their holders must be either capital stockholders or common stockholders, they cannot be both."

> *Bolinger-Franklin Lumber Company v. U. S.A.*, 7 B.T.A. 402;
>
> *Hamlin v. Toledo, St. Louis & K. C. Ry. Co.* (C.C.A. 6) 78 Fed. 664;
>
> *Hazel-Atlas Glass Co. v. Van Dyke & Reeves* (C.C.A.) 8 F. (2d) 716 at 719; cert. den. sub. nom. *Van Dyke v. Young*, 269 U.S. 570, 70 L.ed. 417;
>
> *Angelus Bldg. & Inv. Co.*, 20 B.T.A. 667.

If appellant is to be judged simply by its claims, it should be recognized that the interest deduction

was more than offset by the other entries and treatment of the distributions as dividends upon a participating equity interest. While these two points might be offset against each other, instead of doing this the court ignored the dividend distribution entirely, and held that the claim for interest deduction should offset all other recognition, treatment, intent or purpose of an equity interest, thereby leaving the court "to determine the nature of the debentures and the intention of the issuer and holders thereof from the writing itself" (R. 24). The whole approach of the trial court to the problem goes around and outside of the fundamental question of intent, while at the same time, upon consideration of the debenture alone, it fails to give adequate consideration to the various provisions that indicate the real nature of the obligation. We repeat again that it ignores the realities; as an example, it is utterly inconceivable that any reasonable or sensible person desiring to maintain a creditor position and to obtain an evidence of a debt, would take such an instrument as this which is non-negotiable, bears a return payable only out of net earnings, when, and if available, gives common stock an equal participating earning or right to distribution, and is not enforceable until a date 20 years in the future, without provision for default or acceleration, even in the event of failure of Washmont to meet its obligations. All practical considerations and reasonable probabilities are against that interpretation. The evidence in this case is against it, and the authorities, when they have had occasion to consider similar situations, have reached contrary con-

clusions, as we shall show in the next section of this discussion.

The two provisions which the court considered significant in determining the obligation to be a debt were the promise to pay, and the lien on the company's property. But the first, as we have shown, cannot rationally be considered an absolute promise either superior or equal to the claims of other creditors, and if considered only as a preference against common stock it is entirely consistent with a preferred stock equity. It will be noted that in *Pacific Southwest Realty Company v. Comm., supra*, the certificate purported to give the holder a claim as for a debt and the right to sue in the event of failure to redeem, yet it was held to be a stock interest.

The provision for a lien which the court stresses particularly was not actually effectuated by pledge or mortgage, and as between the corporation and the common stockholders, it is a perfectly consistent provision for preference, and has been many times held not to be inconsistent with the preferred stockholding status or as conclusive in establishing the status of a debt.

4. The Decisions in Similar Cases.

Although we have already discussed a number of the authorities in specific relation to particular points, we desire now, at the risk of some repetition, to review generally the applicable legal rules:

A great many cases have arisen involving the question of whether a particular evidence of interest constitutes the holder a creditor or a shareholder. These

cases are broadly classifiable in two groups. One group comprises those cases arising in bankruptcy, insolvency or other liquidation proceedings calling for the marshalling of assets, where it is necessary to determine the status of the security owner as against the other holders of debt or interests whose rights depend upon the particular instrument. The other group comprises those cases involving public regulation or taxation as, for instance, claims for the allowance of a deduction for interest in determining corporate net income, which would not be allowable if the payments were dividends.

From these decisions two rules or principles are deducible and well established. The first of these is that the designation of the instrument is not controlling and its real character is to be determined by consideration of all of its provisions, together with other facts and circumstances that may properly be considered. The other, which is substantially a corollary of the first, is that the evidence to be considered is not restricted to the written documents and that evidence of the circumstances, purpose and intent of the parties is admissible. This latter rule is perhaps more often recognized and better established in cases of the second group than of the first where the controversy is between parties to the written instrument, since in the second class of cases the controversy is not between the parties but between one of them and the government, and in such cases the parol evidence rule is not applicable and it is always permissible to show the true facts as between the parties to the instrument even though at variance with its terms.

See: Paul & Mertens, Law of Federal Income Taxation §43.74;

Appeal of E. C. Gatlin, 34 B.T.A. 50 at 54.

This court, in *Commissioner v. Proctor Shop, Inc.*, 82 F. (2d) 792, 36-1 U.S.T.C. §9203, recognized both of these rules, in quoting with approval the opinion of the Board of Tax Appeals in the case under review, as follows:

> "None of the decided cases lay down any comprehensive rule by which the question presented may be decided in all cases, and 'the decision in each case turns upon the facts of that case.' * * * In each case it must be determined whether the real transaction was that of an investment in the corporation or a loan to it. On this the designation of the instrument issued by the corporation, while not to be ignored, is not conclusive, * * * The real intention of the parties is to be sought and in order to establish it evidence *aliunde* the contract is admissible. * * * If the evidence establishes 'that dividends paid are, according to the intent of the parties, in fact interest, and the stock on which the dividends are paid is merely held by the creditor as security it makes no difference what the reason was for paying it in that form'."

As pointed out time after time, there is no general rule by which the question can be determined whether in any particular case the security holder is a creditor or a stockholder. It is recognized as fundamental that

> "the essential difference between a stockholder and a creditor is that the stockholder intends to embark upon the corporate adventure, taking the risks of loss attendant upon it that he may enjoy

the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided but merely to lend his capital to others who do intend to take them."

Warren v. King, 108 U.S. 389, 399.

"While no comprehensive rule may be laid down for distinguishing in all cases between an investment in a corporation and a loan to it, one of the most important considerations is whether the right to share in the assets of the corporation in case of dissolution is subject to the rights of creditors. If subject to such right, there is a strong presumption that the interest in question is that of a stockholder."

Helvering v. Richmond, F. & P. R. R. Co. (C.C.A. 4) 90 F. (2d) 971, 37-2 U.S.T.C. §9353.

In the *Proctor* case, *supra*, the instrument was called "debenture preference stock" but was, nevertheless, held to be an evidence of debt. On the other hand, Fletcher, in Volume 6, §2635, of Cyclopedia Corporations, after stating that the name is not conclusive, says:

"For instance, even though an instrument is styled a 'debenture bond,' it is, in effect preferred stock where, by its terms it is made subordinate to the rights of creditors, the interest is cumulative and payable out of earnings, and, on liquidation or dissolution or final distribution of assets, the said bonds are to be entitled to the whole residue of the corporate assets after the payment of debts."

Probably the most definite and practical test that can be applied is whether or not upon a liquidation the

debenture holder in this case would be entitled to share *pro rata* with other general creditors or would be subordinate to them.

The attitude of the Treasury Department in treatment of excess profits cases and classification of borrowed capital, while not conclusive, is, we think, significant. On this subject Regulations 45, Article 812, provides:

> "Art. 812. Borrowed Capital: Securities. Any interest in a corporation represented by bonds, debentures, or other securities, by whatever name called, including so-called preferred stock, if with respect to the payment of either interest or principal it ranks with or prior to the interest of the general creditors, is borrowed capital and cannot be included in computing invested capital. Any such preferred stock may, however, be so included if it is deferred with respect to the payment of both interest and principal to the interest of the general creditors."

See also Art. 23(b)-1 of Regulations 94.

This provision, which was considered significant by the Fourth Circuit in *Helvering v. R.F. & P.R.R. Co., supra,* in dealing with the same kind of a case as the present, states what seems to be the best general rule that can be deduced from the cases that the obligation is stock and not indebtedness if it is deferred with respect to the payment of interest and principal to the other rights of general creditors.

In I.T. 3555, C.C.H. 1942 §6371, a ruling is made by the Treasury Department classifying as stock rather than indebtedness certain so-called debentures having many of the characteristics of those in this

case, which, while not entirely applicable, is significant in a number of respects.

See also *Dayton & Michigan R.R. Co. v. Commissioner* (C.C.A. 4) 112 F. (2d) 627, 40-2 U.S.T.C. §9518, involving guaranteed dividends, secured by a mortgage on the property.

Warren v. King, 108 U.S. 389, 27 L. ed. 769, is a leading case on this general subject, having several points of similarity with this case, especially in that return was payable only out of net income, and contains a very good discussion of fundamental principles, particularly by way of definition of the characteristics of capital at risk in the business.

In re Culbertson's (C.C.A. 9) 54 F. (2d) 753, involved the status of preferred stock in liquidation which it was claimed represented indebtedness because with no voting power, a guaranteed fixed yearly rate of return, and provision for the payment of the par value of the shares at a definite date. But this court held that it was the intention of the parties that such certificates should evidence a participation in earnings and that "the fact that it provides for the redemption of the certificates does not constitute the holder a creditor (14 C.J. 417), and the agreement to pay dividends at stated intervals must be construed to be an agreement to pay the same from the profits."

The crux of the matter is whether or not, in the light of the surrounding facts and circumstances, the debenture holder would be entitled to participate with the other creditors and as one of them upon a liquidation. If not, then the mere fact that a time is fixed

for payment is of no significance, since a definite time is often provided for retirement of preferred stock.

In *Armstrong v. Union Trust & Savings Bank* (C.C.A. 9) 248 Fed. 268, the question arose upon a claim filed in a receivership proceeding by the holder of a certificate evidencing an interest in preferred stock. The obligation was transferrable only on the books of the company, bore interest at 7%, was redeemable at any time after five and prior to ten years at a premium of 5%, and after ten years without premium, and in the case of some of the certificates was accompanied by a rider by which the corporation agreed, upon demand of the holder, to pay the obligation evidenced by the stock at par, with accrued interest, at the end of five years. It will thus be seen that except for its designation as preferred stock, the obligation was, if anything, less a participating or shareholding interest than in this case. After noting the rule that the name is not controlling, the court pointed out that in view of the history of the transaction the intent was to constitute the holder of the obligation a contributor to the capital of the company, and in spite of the specific undertaking to discharge the obligation at a definite time, it held the instrument to be stock and not a debt, saying:

> "No doubt they expected to share in whatever dividends were declared on the stock after payment of the stipulated interest, and to await the declaration of such dividends until the earnings of the capital stock would warrant such action. They could not well expect such dividends and

> at the same time claim that their certificates constituted them creditors. Creditors are entitled to no dividends on their demands. What they might get from the company would go in the way of a discharge of the liability, either partially or entirely. The two positions are wholly inconsistent. They must be considered either stockholders or creditors. They cannot be both. Whatever may be the engagement of the company as between its stockholders, it can have no bearing upon the question for determination. From a review of the entire situation we conclude that these certificate holders are stockholders—preferred stockholders, as the certificates indicate—and not creditors." 248 Fed. 268 at 271.

In the bankruptcy case of *Fechheimer Fishel Co.* (C.C.A. 2) 212 Fed. 357, which has become a leading case on the subject, a claim was presented based on a "debenture bond." The bond contained a provision that it should be subordinate to the general business claims of the company and upon liquidation or dissolution of the company or final distribution of its assets, such creditors should be entitled to priority of payment in full over the bond. It was entitled to interest at 8% per annum and such interest was cumulative and upon liquidation, dissolution or final distribution was entitled, after payment of the debts of the company, to the whole residue of the assets. The bond had a definite due date (see page 366). The bond had, in fact, been superseded by a note issued in place thereof on which the claim was directly made, but in passing on the matter the court considered it upon the basis of the nature of the bond. After

referring to the matters above mentioned, the court said:

> "All these features are quite characteristic of stock. They are not at all characteristic of bonds. And we are satisfied that no error was committed by the court below in holding that these so-called 'bonds' were in effect preferred stock." (p. 360) * * * "Assuming that the bond was nothing more than preferred stock, it is necessary to consider whether the fact that it had a definite due date affords any sufficient reason for distinguishing it from stock not so limited in time, and making it necessary to hold that all who became creditors after the due date, or after the date of the first note or the date of the renewal note should be held to have no claim superior to Rothenberg's upon the assets of the corporation. * * * The due date of the bond and the due date of the note are alike immaterial under the circumstances of the case. At the best they only indicated a time when a reduction of the capital stock might have been made under the agreement, but, as the reduction was not made, it may be disregarded" (p. 366).

In *Kentucky River Coal Corporation*, 3 B.T.A. 644, the taxpayer sought a deduction, as for interest, for dividends paid upon its debenture stock during the year. The debenture stock was entitled to 6% return, was retirable with a premium after three years at the option of the company, and was required to be paid off at the end of ten years at par. Dividends were payable only out of surplus profits or earnings, but were cumulative. The Board, after reviewing a number of cases involving similar obligations which had a fixed maturity date, at which time they became due and could be required to be discharged, held "that

the dividends paid by the taxpayer upon its shares of debenture stock outstanding during the year 1919 were not the equivalent of interest paid on indebtedness."

The same question came before the District Court of Kentucky upon a suit for refund involving a different year, entitled *Kentucky River Coal Corporation v. Lucas*, 51 F. (2d) 586, 10 A.F.T.R. 279, affirmed without opinion by the Circuit Court of Appeals for the Sixth Circuit at 63 F. (2d) 1007, 12 A.F.T.R. 356. The District Court said:

> "The entire capital of the plaintiff corporation was represented by the property transferred to it by the five selling corporations, and the debenture stock is just as much reflected in this property as is the common and preferred stock.
>
> "The debenture stock, when issued, was styled 'debenture stock,' and provided that the stipulated dividend of 6 per cent should only be paid out of the surplus profits, earnings, or assets of the corporation, a typical provision as to preferred stock, as distinguished from ordinary indebtedness." * * *
>
> "Nor do I think the unconditional undertaking to redeem the stock at par at the end of ten years destroys its nature as capital stock. The stockholders among themselves undoubtedly had the right to make such an agreement. If its enforcement rendered the corporation incapable of meeting its obligations to those general creditors whose claims were within the $25,000 debt limitation, I have no doubt the courts would hold that the rights of the holders of these debenture shares were subordinate to the rights of these general creditors.

> "I am constrained therefore to agree with the Board of Tax Appeals in its decision involving exactly this same question with the same taxpayer, and reported in 3 B.T.A. 644."

The principal reasons assigned by the lower court for holding the debentures to be a debt were: That they matured at a definite date and recited that they constitute a lien on the property of the company. As to the maturity, that is immaterial, provided they are subordinate to the claims of creditors. It is like an issue of preferred stock which may be retired at a fixed date. In this sense, of course, all stock has a maturity date fixed at the life of the corporation. In addition to cases cited above on this point, we refer to the following:

Finance & Investment Corp. v. Burnet (D.C. App.) 57 F.(2d) 444, 10 A.F.T.R. 1560, holding so-called preferred stock entitled to cumulative 8% dividends and redeemable at the election of the holder, to be stock and not indebtedness and payments thereon not deductible as interest.

Appeal of Dodd, Mead & Company, Inc., 43 B.T.A. 739 at 747, holding certificates represented stock rather than indebtedness, although required to be redeemed at specified times.

Elko LaMoille Power Co. v. Commissioner (C.C.A. 9) 50 F.(2d) 595, 10 A.F.T.R. 53, holding that certificates redeemable at election of the company at a certain time and sold upon representation that they would be redeemed on demand, ratified by the board of directors, constituted stock and not a debt.

Angelus Bldg. & Investment Co., 20 B.T.A. 667,

holding that certificates containing a provision for retirement on which payments were made as interest, were in fact stock and not indebtedness.

As to the provision for a lien, there was no mortgage or evidence of security or priority other than the statement in the debenture certificate which relates to no specific property and in law is absolutely meaningless as to creditors. Several of the cases have involved instruments containing language of that kind used in connection with preferred stock and have considered it of no significance except as to determining rank or preference between the equity holders. Typical of such cases is *Weaver Power Co. v. Elk Mountain Milling Co.*, 69 S.E. 747, holding that certificates of stock reciting that they constituted a preferred lien on the assets of the company were, nevertheless, stock and not a debt, the preference being only as between stockholders.

See also:

Hamlin v. Toledo, St. Louis & K. C. Ry. Co., (C.C.A. 6) 78 Fed. 664;

Dayton & Michigan R. R. Co. v. Comm. (C. C.A. 4) 112 F.(2d) 627; 40-2 U.S.T.C. §9518 (where the lien was put in the form of a mortgage);

Warren v. King, 108 U.S. 389, 27 L. ed. 769;

Spencer v. Smith, 201 Fed. 647, 124 A.L.R. 1070, 29 A.L.R. 254, 262.

As bearing generally on the principles above discussed, see:

Fidelity Savings & Loan Ass'n. v. Burnet (C. of A., D.C.) 65 F.(2d) 477;

Bakers Mutual Co-op Assn. v. Comm. (C.C.A. 3) 117 F.(2d) 27, 41-1 U.S.T.C. §9181;

Brown-Rogers-Dixon Co. v. Comm. (C.C.A. 4) 122 F.(2d) 347, 41-2 U.S.T.C. §9657;

Policyholders National Life Assurance Co. v. Comm., 37 B.T.A. 60;

Ticker Publishing Co., 46 B.T.A. No. 50;

cf. *Jewel Tea Co. v. U. S.*, 90 F.(2d) 451, 37-2 U.S.T.C. §9331.

CONCLUSION

We think it is clear that, even if considered wholly by itself, the debenture in this case is not such an instrument as would ordinarily be drawn or received by a creditor to denote a debt, and that considering all of its terms and provisions it would never rank with the claims of other creditors. When in addition to the language of the instrument itself, there is considered the uncontradicted testimony as to the reason and purposes controlling its issuance, it is apparent that it constituted capital at risk in the business. The action of Associated in accepting a new issue of preferred stock clearly defining that position is significant. The debentures certainly would not rank on a par with other indebtedness of Washmont, and giving due consideration to all of the various terms of the instrument, the significance of which has been stressed by the decided cases, the circumstances surrounding their issuance, and the intent and purpose of those who issued and received them, it is submitted that they should be classified as stock and not a debt and that,

therefore, appellant was not a personal service corporation and is entitled to recovery of the tax here involved.

Respectfully submitted,

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